

ORIGINAL REHEARING 12/2/08



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AZ CORP COMMISSION  
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

IN THE MATTER OF THE APPLICATION  
OF GOLD CANYON SEWER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE  
OF ITS UTILITY PLANT AND PROPERTY  
AND FOR INCREASES IN ITS RATES  
AND CHARGES FOR UTILITY SERVICE  
BASED THEREON.

DOCKET NO: SW-02519A-06-0015

**GOLD CANYON SEWER COMPANY'S**

**PETITION FOR REHEARING**

**PURSUANT TO A.R.S. § 40-253**

Arizona Corporation Commission

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**DEC -5 2008**

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## TABLE OF CONTENTS

I.	INTRODUCTION. ....	1
II.	THE ISSUES ON WHICH REHEARING IS SOUGHT. ....	2
	A. The Reduction of the Company's Rate Base by \$1 Million. ....	2
	B. The Use of 8.54 Percent as the Rate of Return Is Arbitrary and Unlawful. ....	5
	C. Other Issues Raised For Rehearing. ....	9
III.	CONCLUSION. ....	10

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1     **I. INTRODUCTION.**

2           Pursuant to A.R.S. § 40-253, Gold Canyon Sewer Company ("GCSC" or "the  
3     Company") petitions the Arizona Corporation Commission ("the Commission") for  
4     rehearing of Decision No. 70624 (November 24, 2008) ("the Rehearing Decision").

5           On August 1, 2007, the Commission granted application of the Residential Utility  
6     Consumer Office ("RUCO") for rehearing of Decision No. 69664 (June 28, 2007) ("the  
7     Original Decision") under A.R.S. § 40-253. The "two specific issues" raised in RUCO's  
8     rehearing application were that "(1) the Commission should have disallowed from rate  
9     base \$2.8 million to reflect what RUCO claims is excess capacity in Gold Canyon's  
10    wastewater treatment plant; and (2) the Commission should have adopted RUCO's  
11    hypothetical capital structure of 60% equity and 40% debt, rather than the actual 100%  
12    equity capital structure used by the Commission to calculate the Company's cost of  
13    capital." (Rehearing Decision at 3, Finding of Fact ("FOF") 2.)

14          Based on RUCO's request, and following three days of hearing and additional  
15    briefing, the Commission ultimately issued the Rehearing Decision. That decision  
16    modified the Original Decision in two specific ways:

17                   IT IS THEREFORE ORDERED that Gold Canyon Sewer  
18                   Company's rate base be reduced by \$1.0 million as discussed  
19                   herein and that Gold Canyon Sewer Company submit by  
20                   November 30, 2008, for Commission approval, rates and  
21                   charges revised per this rate base reduction. These revised  
22                   rates and charges will be applied on a prospective basis and  
23                   will not be applied retroactively.

24                   ...

25                   IT IS FURTHER ORDERED that the weighted cost of capital  
26                   approved in this case shall be 8.54 percent and that Gold  
                    Canyon Sewer Company submit by November 30, 2008, rates  
                    and charges revised per this cost of capital. These revised  
                    rates and charges will be applied on a prospective basis and  
                    will not be applied retroactively.

1 (Rehearing Decision at 15-16.)

2 Unfortunately, both of these orders were unsupported by substantial evidence, and  
3 were arbitrary, capricious or otherwise unlawful for the reasons explained herein. The  
4 Company also incorporates by reference its Rehearing Closing Brief, filed on May 5,  
5 2008, and its Rehearing Reply Brief, filed on May 22, 2008, and the evidence and  
6 arguments set forth therein in support of this petition.

7 **II. THE ISSUES ON WHICH REHEARING IS SOUGHT.**

8 **A. The Reduction of the Company's Rate Base by \$1 Million.**

9 The Commission adopted RUCO's position that the Company's wastewater  
10 treatment plant has excess capacity and ordered that the Company's "rate base" be  
11 reduced by \$1 million. (Rehearing Decision at 15.) This reduction to the Company's  
12 rate base is unsupported by substantial evidence, and is arbitrary, capricious and  
13 otherwise unlawful for several reasons, including the following:

14 1. The Company does not have any excess wastewater treatment capacity.  
15 RUCO presented no credible engineering or operational evidence that the Company's  
16 wastewater treatment plant contained excess capacity. In fact, none of RUCO's  
17 witnesses were even qualified to express an opinion on the required capacity. RUCO  
18 instead had its rate analyst make a purely mathematical calculation and then argued for  
19 disallowance from rate base of that prorated portion of the plant value as excess capacity.  
20 RUCO's methodology is also flawed because it is based on average, rather than peak,  
21 wastewater flows. (Rehearing Decision at 4-5, FOF 5,6 and 8.) RUCO failed to present  
22 anything that constitutes substantial evidence. Therefore, RUCO failed to sustain its  
23 burden of proof that any portion of the Company's plant was not used and useful, and the  
24 resulting reduction to the Company's rate base is unlawful.

25 2. GCSC designed and built the amount of wastewater treatment capacity  
26

1 necessary to comply with the Commission's expectation that sewer utilities plan and  
2 build treatment capacity to serve customers over a five-year future planning horizon to  
3 ensure that safe and reliable service will be furnished. (Rehearing Decision at 4-5, FOF 7  
4 and n 2.) Similarly, ADEQ requires that a sewer utility begin planning for additional  
5 treatment capacity when plant throughput reaches 80% of permitted capacity and begin  
6 constructing that additional capacity before 90% of permitted capacity throughput is  
7 reached. (*Ibid.*; *see also id.* at 8, FOF 16 and 17.) The Company's wastewater treatment  
8 plant was designed and built to comply with these regulatory requirements. This is  
9 supported by the Staff report and Staff expert witness testimony. Therefore, none of this  
10 capacity is "excess capacity."

11 3. The arbitrary reduction to rate base is in part based on the inclusion of  
12 information that could not have been known to GCSC at the time it had to plan for the  
13 renovation and expansion of the treatment plant, or at the time the plant was constructed,  
14 or even well after the construction was completed. Indeed, RUCO's accounting witness  
15 acknowledged that the Company's decision to renovate and expand its treatment plant  
16 was reasonable and prudent under the circumstances known in the 2004 - 2005 time  
17 frame decisions had to be made. (Rehearing Decision at 4, FOF 6.) For example,  
18 RUCO's witness stated:

19 We commend the Company for its proactive approach to  
20 eliminating the odor and noise and the customer problems  
21 with the undercapacity of existing plant when they took it  
over.

22 (Hearing Transcript at 943. *See also id.* at 957-58, 962-63, 988.)

23 Despite this testimony, the Commission has now second-guessed GCSC based on  
24 information that was not known to the Company, and that could not have been known to  
25 the Company, when it was obliged to design and construct its plant renovation and  
26 expansion. For example, in February 2005, GCSC experienced peak flows of almost 1.2

1 million gallons per day ("gpd"), 80% of its minimum necessary capacity of 1.5 million  
2 gpd. (Rehearing Decision at 4, FOF 7; *see also id.* at 8, FOF 17.) Furthermore, based on  
3 growth projections at that time, Staff's engineering witness estimated that GCSC was  
4 likely to have peak flows in excess of 1.5 million gpd in 2007. (*Ibid.*) As such, GCSC  
5 would have been obligated to have capacity substantially greater than 1.5 million gpd in  
6 place by then or already be re-engaged in constructing additional capacity to meet  
7 ADEQ's expectations and the Commission's required 5-year forward planning horizon.  
8 The Commission's rules require that plant investment decisions be evaluated based on  
9 information that was known or should have been known at the time plant investment  
10 decisions had to be made. A.A.C. R14-2-103(A)(3)(I). Here, the Commission has  
11 ignored its own rules, and arbitrarily reduced GCSC's rate base by \$1 million just  
12 because reasonably anticipated growth failed to occur several years after a prudent  
13 amount of capacity was constructed. This was unlawful.

14 4. Even if the Commission's rules and the lack of evidence in the record of  
15 "excess capacity" are ignored, the Commission's rate base adjustment is substantially  
16 overstated. First, the Commission removed \$1 million from the Company's rate base.  
17 The issue is whether the Company's plant in service contained excess capacity. RUCO's  
18 own recommendation was for a roughly \$2.8 million plant adjustment that, with  
19 necessary conforming plant adjustments (i.e., deferred income taxes, depreciation), only  
20 reduced RUCO's recommended rate base by approximately \$1.8 million.

21 Additionally, as stated, there was no dispute that in early 2005, peak flows  
22 approached 1.2 million gpd and, therefore, that a minimum of 1.5 million gpd of  
23 treatment capacity was needed to ensure safe and reliable service. (Rehearing Decision at  
24 4-5, FOF 7; *id.* at 8, FOF 17.) At most, therefore, the cost of the additional 400,000 gpd  
25 of treatment capacity (i.e., building a plant with a capacity of 1.9 million gpd rather than  
26 1.5 million gpd) was potentially subject to disallowance, as the Commission has

1 acknowledged. (Rehearing Decision at 8, FOF 17.) Moreover, there is no dispute that  
2 the incremental cost of adding 400,000 gpd of capacity was less than \$1 million.  
3 (Rehearing Decision at 4-5, FOF 7 and n. 3; *id.* at 8, FOF 17.) One of the Commissioners  
4 acknowledged during the Open Meeting that the order was faulty and had no basis in fact.

5 So, approximately, approximately a million dollars isn't a  
6 million dollars. It is some other number; we just don't know  
7 what it is.

8 This is a faulty, it is a faulty order. The only reason we are  
9 doing it is to lower the rates somehow and find a way to do it.  
10 It is not, we are not using any real math here or any kind of  
11 real process. We are just trying to drive the rates down.

12 Transcript from November 13, 2008 Open Meeting ("OM Tr.") at 221.

13 In the final analysis, the Commission has adopted a flawed methodology contrary  
14 to its own rules and penalized the Company for acting prudently to ensure that safe and  
15 adequate treatment capacity is available at a reasonable cost.

16 **B. The Use of 8.54 Percent as the Rate of Return Is Arbitrary and Unlawful.**

17 In addition to arbitrarily reducing GCSC's rate base by \$1 million, the  
18 Commission ordered that the Company's return on rate base be reduced to 8.54 percent.  
19 (Rehearing Decision at 16.) This return was derived by adopting RUCO's recommended  
20 return on equity of 8.6 percent, RUCO's recommended cost of debt of 8.45 percent, and  
21 RUCO's hypothetical capital structure of 40% debt and 60% equity. The order to utilize  
22 a weighted average cost of capital of 8.54 percent is unsupported by substantial evidence,  
23 is arbitrary, capricious or otherwise unlawful for several reasons, including the following:

24 1. RUCO did not seek rehearing on the return on equity. RUCO's rehearing  
25 application made no mention of its recommended return of 8.6% and did not ask that the  
26

1 Commission adopt a different return on equity than that adopted in the Original Decision.  
2 (See, e.g., Rehearing Decision at 3.) Thus, adoption of RUCO's return on equity of 8.6  
3 percent violates A.R.S. § 40-253. This statute requires that an application for rehearing  
4 "set forth specifically the grounds on which it is based." A.R.S. § 40-253(C) (emphasis  
5 supplied).

6 2. In the Original Decision, the Commission provided a detailed discussion of  
7 the basis for adopting Staff's recommended cost of equity of 9.2%. The Commission  
8 explained, for example, that the "[publicly traded] companies in Staff's sample group are  
9 appropriate because they have objective data that is publicly available through *Value Line*  
10 and other investor publications." (Original Decision at 28.) RUCO used a different  
11 sample group in its cost of equity estimate. Similarly, the Commission explained that  
12 "Staff's expert witness relied on a constant growth DCF model, a two-stage DCF model,  
13 and a two-part CAPM analysis for calculating his cost of equity capital, consistent with a  
14 long-line of prior Commission decisions that have adopted comparable methodologies for  
15 determining cost of capital." (*Id.* at 29.) RUCO used much different versions of the  
16 models. In fact, RUCO never challenged Staff's recommended return on equity of 9.2%  
17 or questioned the methods used by Staff to derive that return, as evidenced by the  
18 discussion in the Rehearing Decision. (Rehearing Decision at 9-11, FOF 20-23.) The  
19 Rehearing Decision fails to explain why RUCO's models and their inputs, as well as  
20 RUCO's sample group of publicly traded companies, are superior to those that have been  
21 consistently approved "in a long line of prior Commission decisions" and should be used  
22 in this case. This is arbitrary and unlawful.

23 3. RUCO's recommended cost of debt was a fiction. There is no record of  
24 testimony or discussion in this case as to the availability of or the cost of debt for utilities  
25 of this size and type. No evidence was presented to show that GCSC could borrow more  
26 than \$6 million at the cost of debt imputed in this decision or at any other cost. This sort



1 of fictitious ratemaking is not supported by substantial evidence and is arbitrary and  
2 capricious.

3 4. RUCO's recommended hypothetical capital structure is a fiction supported  
4 by the Commission. The Company's actual capital structure is 100% equity, and in the  
5 Original Decision, consistent with well-established practice, the Commission approved a  
6 downward adjustment of 100 basis points to the cost of equity to account for the assumed  
7 lower financial risk associated with a 100% equity capital structure. This adjustment was  
8 deemed appropriate and sufficient to yield a fair and reasonable return to the Company  
9 based on its 100% equity capital structure. The use of a hypothetical capital structure  
10 may be another means of accounting for the level of financial risk the utility faces, but  
11 the use of the associated fictitious assumptions and adjustments that could accompany it  
12 (and lower the Company's revenue requirement) is without substantial evidence, and is  
13 arbitrary and capricious.

14 5. The Rehearing Decision conflicts with *Black Mountain Sewer Corp.*,  
15 Decision No. 69164 (Dec. 5, 2006). The GCSC and Black Mountain rate cases involve  
16 virtually identical circumstances and were decided by the Commission within eight  
17 months of each other. In fact, Black Mountain's application for rate increases was filed  
18 on September 16, 2005, while GCSC's application for rate increases was filed on  
19 January 13, 2006, only four months later. Decision No. 69164 at 1; Rehearing Decision  
20 at 1. The common stock of both sewer utilities was acquired by Algonquin Water  
21 Resources of America in 2001. (Decision No. 69164 at 2; Original Decision at 1-2.) The  
22 service territories of both sewer utilities are on the outskirts of the Phoenix metropolitan  
23 area, and are approximately 30 miles apart. (Decision No. 69164 at 1.) Finally, and most  
24 importantly, for ratemaking purposes both sewer utilities have capital structures  
25 consisting of 100 percent equity and no debt. Decision No. 69164 at 19; Decision at 24.  
26 In other words, GCSC and Black Mountain are two truly comparable utilities that had

1 applications for rate increases pending before the Commission at the same time.

2 In Black Mountain's case, Black Mountain and Staff recommended the use of the  
3 sewer utility's 100% equity capital structure, while RUCO proposed a hypothetical  
4 capital structure containing 57 percent equity and 43 percent debt. (Decision No. 69164  
5 at 19.) The Commission rejected RUCO's proposed hypothetical capital structure,  
6 concluding that a capital structure comprised of 100 percent equity should be used in  
7 calculating Black Mountain's cost of equity. The Commission stated: "We believe  
8 RUCO's hypothetical capital structure recommendation is results oriented and is not  
9 consistent with the Company's actual capital structure." (Decision No. 69164 at 20.)

10 Instead, the Commission adopted Staff's recommended capital structure,  
11 containing 100 percent equity, as well as Staff's 9.6 percent return on equity and Staff's  
12 9.6 percent return on rate base. (*Id.* at 26-27.) The Commission expressly determined  
13 "that adoption of Staff's recommendation results in a just and reasonable return for  
14 [Black Mountain]," and further found that a "rate of return on [rate base] of 9.60 percent  
15 based on a capital structure of 100 percent common equity is reasonable and  
16 appropriate." (*Id.* at 27, 39.)

17 The findings in that proceeding should be controlling in GCSC's case. There is  
18 nothing that distinguishes Black Mountain from GCSC. Both utilities are small sewer  
19 utilities owned by the same parent and provide similar services in same general area. The  
20 plant owned by both utilities and used to furnish service is financed entirely by equity  
21 with no debt in the balance sheet. In Black Mountain, RUCO's hypothetical capital  
22 structure was rejected as "results oriented," and RUCO did not challenge that finding.  
23 Therefore, given the close similarity between the two sewer utilities and the fact that the  
24 two cases substantially overlapped, the Commission's adoption of a hypothetical capital  
25 structure for GCSC is arbitrary and capricious. Its adoption in this instance is blatantly  
26 "results oriented" and was rejected by the Commission in the Black Mountain case for

1 precisely that very same reason.

2 **C. Other Issues Raised For Rehearing.**

3 1. As stated, RUCO sought rehearing of the Original Decision pursuant to  
4 A.R.S. § 40-253. This statute requires that the “application set forth specifically the  
5 grounds on which it is based.” A.R.S. § 40-253(C). As the Commission correctly states  
6 in the Rehearing Decision, RUCO raised two specific issues in its application—excess  
7 capacity and hypothetical capital structure. Nevertheless, two Commissioners voting to  
8 approve the rate reductions approved in the Rehearing Decision specifically justified their  
9 votes on odor issues that the Commission previously determined were resolved and on  
10 statements made by the Company’s past President. (*See* OM Tr. at 107-111, 160-163,  
11 and 168.) Both of these issues were addressed in detail and subject to specific findings of  
12 fact and final resolution in the Original Decision. (Original Decision at 30-35 (odor  
13 issues), 36-42 (prior statements by Mr. Hill) and FOF 41 and 42.) Moreover, these issues  
14 were not raised in RUCO’s rehearing application, and cannot be reheard or otherwise  
15 used as a basis to lower the Company’s revenue requirement. Therefore, the Commission  
16 violated A.R.S. § 40-253.

17 2. The Rehearing Decision rejected GCSC’s request to recover \$90,000 of  
18 additional rate case expense for the rehearing. The Commission concluded that there was  
19 insufficient evidence to support an award of this expense. (Rehearing Decision at 14-15,  
20 FOF 34-37.) However, the Company presented evidence showing that it had incurred  
21 more than the \$90,000 requested. (E.g., Rh. Tr. at 494-495, 502-503) Staff supported  
22 recovery of at least \$73,000 in rehearing rate case expense. (Rh. Tr. at 495-496.) The  
23 Rehearing Decision, however, erroneously states that Staff declined to recommend  
24 recovery of rehearing rate case expense. (Rehearing Decision at 14-15, FOF 36.) RUCO  
25 took no position. (*Id.*) Accordingly, the denial of rate case expense for a proceeding in  
26

1 which GCSC was forced to participate by the Commission is contrary to the evidence in  
2 the record, and is arbitrary and capricious.

3 3. The modification of the Company's revenue requirement as adopted in the  
4 Original Decision was, by the Commissioners' own admission, simply an effort to reduce  
5 GCSC's revenues through any means possible. *See, e.g.,* OM Tr. at 17, 111, 219-220,  
6 and 221. Such results-oriented ratemaking is unlawful, arbitrary and capricious because  
7 it does not result in an opportunity to earn a fair return on rate base and does not result in  
8 just and reasonable rates.

9 **III. CONCLUSION.**

10 For these reasons, the Commission should rehear this matter and issue a new order  
11 consistent with the foregoing and the evidence in the record.

12 RESPECTFULLY SUBMITTED this 5<sup>th</sup> day of December, 2008.

13 FENNEMORE CRAIG, P.C.

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21 ORIGINAL and thirteen (13) copies of the  
22 foregoing were filed this  
23 5<sup>th</sup> day of December, 2008 with:

24 Docket Control  
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1 COPIES were hand-delivered this  
2 5<sup>th</sup> day of December, 2008  
3 to the following:

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